Governance Insights Center
Executive Compensation Series

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Legal and regulatory requirements

To provide effective board oversight, compensation committees have to understand myriad standards and regulations. Here, we explain their duties and the rules that drive them.

Reporting requirements, proxy rules, and listing standards dictate many compensation committee responsibilities. We examine the legal basis for these responsibilities and what compensation committees need to consider.

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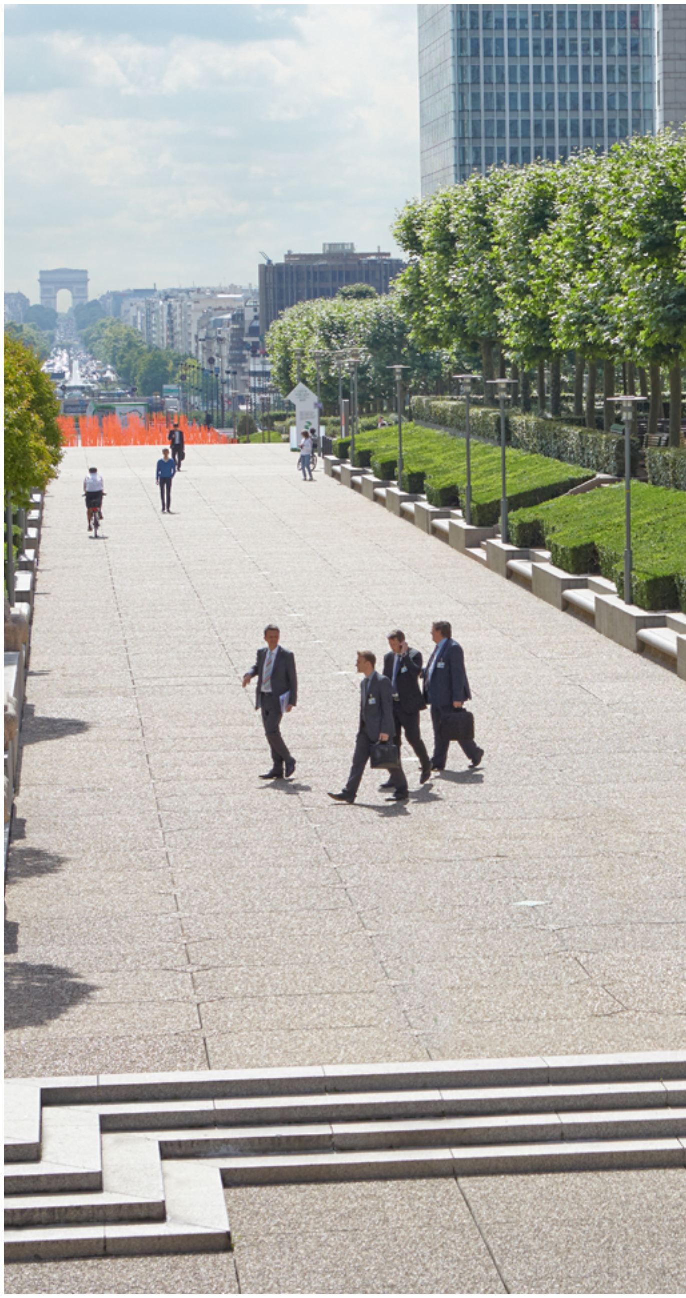
Fiduciary law—and its impact on compensation committee members

There are three key concepts in fiduciary law that directors should understand: the business judgment rule, which protects good faith business decisions, and the duties of care and loyalty, which directors owe to the company's shareholders.

The business judgment rule

The business judgment rule is a fundamental principle of corporate governance, and it allows boards of directors to take risks without the threat of liability for a decision that does not work out. Under the rule, courts presume that directors have complied with their fiduciary duties when making business decisions by acting in good faith, without self-interest, and with reasonable care and prudence. The business judgment rule applies to board decisions, including those regarding executive compensation.



Deeper insights

The business judgment rule, especially as applied by the Delaware courts, provides protections for directors against claims that they may have made an error in judgment. However, there are limits to the protections, and boards should not expect to be able to "hide behind" the business judgment rule when their decision-making process or disinterestedness are called into question. If a board cannot rely on the business judgment rule to dispose of a lawsuit, board members may find themselves in uncomfortable and costly depositions or even giving testimony at a trial. The optics of the situation often take an outsized importance.

The duty of care

When making business decisions, directors owe shareholders a duty of care—meaning they must exercise diligence and be informed and deliberate in making decisions. How detailed should this diligence exercise be? For decisions that compensation committee members make, the courts have indicated that directors should understand the material terms, the "escape hatches" or ways in which the contract can be terminated, and the potential consequences if parties' interests diverge. Directors should not be overwhelmed with too much information, but their decisions should be informed by knowledge of important economic terms.

The duty of loyalty

A board member's second key fiduciary duty is to be loyal to the company and its shareholders and to act in their best interests. For compensation committee members, the duty of loyalty is focused on their independence from management, particularly the chief executive officer (CEO). Independence—not just compliance with the technical requirements—should be the goal. Any type of relationship, financial or otherwise, between a director and a CEO is relevant.

The importance of documenting compensation decisions

Failure to properly document a board's decisions can lead to unnecessary costs and risks. The long-running Disney case (concerning severance paid to former CEO Michael Ovitz) is a primary illustration of what can go wrong regarding fiduciary duty. While the courts eventually concluded that the director defendants did not breach their fiduciary duties or commit waste, the favorable resolution for directors still cost the company years of litigation that could have been avoided with proper documentation.

Questions for directors:

- *Does the written record reflect the board's receipt and review of the principal business terms of any key agreements and any changes to those agreements?*
- *Have all personal, business, or financial connections between directors and senior executives been fully disclosed to other members of the board and the board's counsel?*

Securities law—proxy and other types of disclosure

Proxy review process

A company's proxy statement is principally the responsibility of management, who usually drafts the document. The proxy statement should accurately and persuasively convey the compensation committee's thinking behind pay decisions and explain in clear and concise terms why the committee's decisions are consistent with the company's business goals and performance.

Compensation Discussion and Analysis

The Compensation Discussion and Analysis (CD&A) section of the proxy statement is designed to provide shareholders with the information necessary to understand the company's compensation policies and decisions with regard to senior executives. The CD&A must cover compensation policies and decisions made during the prior year. It should also address any other matters necessary for an investor to understand the prior year's compensation program.

NEOs and compensation

The focus of the proxy is on the compensation of "named executive officers" (NEOs): any person acting as CEO or chief financial officer (CFO) during the prior year, the three most highly-compensated executive officers (other than the CEO and CFO) who were employed at year-end, and any other executive officer who would have been in the top three but was not employed at year-end.

What about performance targets?

Disclosure of performance targets in the CD&A is a common concern among companies. The proxy disclosure rules require disclosure of performance targets if they are material to an understanding of the company's executive compensation policies or decisions.

The rules do not require the disclosure of performance targets that involve confidential trade secrets or confidential commercial or financial information if disclosure would result in the potential for competitive harm, but this exception is very narrowly interpreted by the SEC.

Deeper insights

Public companies' annual proxy statements have evolved from being dry legal disclosure documents to being vehicles for shareholder engagement – i.e., dialogues between the boards of directors and shareholders. While detailed compensation disclosure is still required, and typically requires more than 30 pages of text, it is critical that the document also include readable, understandable information about the company's executive compensation policy, management performance, and the roles of the board and management in governance.

Companies are increasingly customizing their CD&A disclosure with graphics that make it more reader-friendly and highlight important business trends, good governance practices, and pay-for-performance alignment.

Compensation tables

Summary Compensation Table

The disclosure of executive compensation is mostly comprised of a series of required tables, including a Summary Compensation Table. This table, together with extensive required footnotes, provides a summary of the compensation of the NEOs for the prior three fiscal years.

The "Total" compensation column of the Summary Compensation Table is the prime focus of the press and others who look for the size of the CEO's paycheck. However, this total reflects the addition of compensation measured in different ways and earned over different periods of time, which some critics say is like adding apples and oranges.

Some noteworthy aspects of the Summary Compensation Table reporting requirements

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Non-qualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Executive A Chairman and Chief Executive Officer	2015	1,287,500	–	7,860,622	2,241,176	2,020,000	3,390,703	481,598	17,281,599
	2014	1,250,000	–	7,493,591	2,096,815	2,048,200	6,026,605	502,295	19,417,506
	2013	1,237,500	250,000	7,176,489	2,265,976	2,650,000	917,847	490,026	14,987,838
Executive B Senior Vice President and Chief Financial Officer	2015	669,750	–	1,657,199	472,474	686,887	270,747	143,413	3,900,470
	2014	649,250	–	1,539,248	430,701	669,761	168,481	139,335	3,596,776
	2013	163,790	960,000	2,302,436	65,408	218,050	29,347	364,657	4,103,688
Executive C Executive Vice President for Industry Vertical #1	2015	677,500	–	1,487,163	424,016	680,801	1,132,731	135,778	4,537,989
	2014	655,000	–	1,336,792	374,026	787,041	1,159,571	150,536	4,462,966
	2013	604,167	–	1,939,504	362,505	855,547	356,770	186,124	4,304,617
Executive D Executive Vice President for Industry Vertical #2	2015	565,000	–	1,062,301	302,865	212,923	609,249	95,904	2,848,242
	2014	550,000	–	972,208	272,024	384,005	815,343	94,916	3,088,496
	2013	492,250	–	1,652,530	284,102	397,354	392,678	88,626	3,307,540
Executive E Executive Vice President for Industry Vertical #3	2015	570,000	–	1,019,759	290,761	497,357	633,107	100,193	3,111,177
	2014	548,250	–	891,174	249,361	483,119	985,227	114,066	3,271,197
	2013	523,500	100,000	902,256	275,006	615,125	46,862	87,814	2,550,563

- Discretionary payments are disclosed as "Bonus" while formulaic incentive payments are disclosed as "Non-Equity Incentive Plan Compensation."
- Perks and personal benefits are generally included in the Summary Compensation Table. The SEC has not provided a bright line rule for what is and what is not a "perquisite," but generally an item that is directly related to the performance of the executive's duties is not a perk, while an item that confers a direct or indirect benefit that has a personal aspect is a perk. Perquisites are measured by the "aggregate incremental cost" to the company of providing the benefit, which is usually different from the value of the perk for tax purposes.
- Severance, including accelerated vesting of equity awards, is generally included in the Summary Compensation Table under "All Other Compensation," which can cause a former executive officer who ordinarily would not have been a top-three executive to be included as an NEO. But, if the obligation to pay severance is subject to a non-compete obligation, then the severance may not need to be included in the Table.

Other required detailed compensation tables and narrative disclosures

Disclosure	Format and type of information
Grants of plan-based awards	Tabular disclosure of the principal terms of cash- and equity-based incentive awards for the last year
Employment and severance agreements	Narrative summary of individual employment and severance agreements
Outstanding equity awards	Tabular disclosure of outstanding awards as of the end of the last year
Option exercises and stock vested	Tabular disclosure of realized equity-based compensation in the last year
Pension benefits	Tabular disclosure of broad-based defined benefit pension plans
Non-qualified deferred compensation	Tabular disclosure of executive deferral plans
Termination or change-in-control payments	Tabular or narrative disclosure of payments and benefits in the event of a change-in-control or termination of employment

Potential payments on termination or change-in-control

In addition to conducting regular say-on-pay votes and disclosing change-in-control compensation required as part of the CD&A, companies seeking shareholder approval of a merger, asset sale, or similar transaction are generally required to solicit an advisory shareholder vote. The vote covers payments to be made to the NEOs in connection with the transaction, including potential value of cash severance, cashed-out or accelerated equity awards, and other benefits and perquisites.

This advisory vote has much less practical consequence than the regular say-on-pay vote because the vote is only required when the company is being sold. While the vote can still have important reputational consequences for directors, problematic votes are rare: only 16 of the 300 companies (5.3%) that held say-on-golden-parachutes votes in 2014 and 2015 received less than majority support.

Questions for directors:

- *Is the compensation committee aware of current market practices for change-in-control pay, as well as the perspectives of shareholders, proxy advisors, and regulators on this topic?*
- *Does the compensation committee understand the quantitative impact of special or new awards under change-in-control arrangements, and how double-trigger and performance-based vesting conditions would work after a sale?*

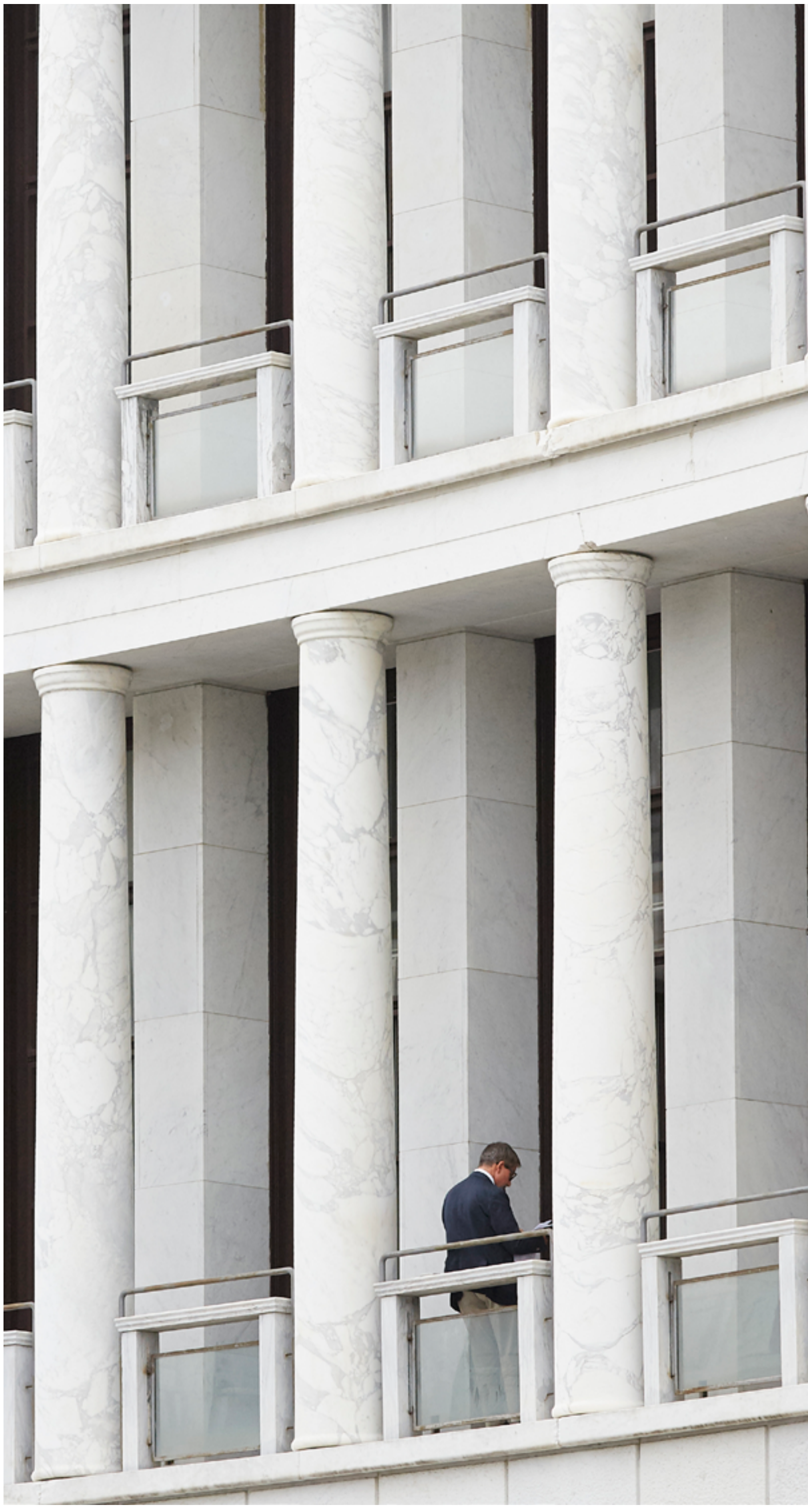
Compensation practices and risk management

The perception that executive pay practices contributed to the 2008 financial crisis gave rise to a requirement that companies disclose in their proxy statement whether their compensation policies and practices are reasonably likely to have a material adverse effect on the company. Directors are advised to consider this question on an annual basis, but few, if any, companies have actually disclosed that their pay practices gave rise to material risks.

Corporate governance

Companies are required to include in their annual proxy statement details about:

- Director and director-nominee independence
- The number of full board and committee meetings held in a given year and certain details about attendance
- The committees' members, duties, and interaction with management
- The committees' compensation consultant, if one is used, and fees paid if the consultant provided significant additional services to the company during the year
- Compensation committee "interlocks," (i.e., reciprocal service by executive officers/directors on each other's compensation committees)



Transactions with related parties

Companies are required to disclose in their proxy statements transactions in which a "related person" has or may have a material interest. A "related person" includes any director, director-nominee, or executive officer of the company, and any immediate family member of any such person. Compensatory payments are generally not required to be reported as related-party transactions, although disclosure may be required in certain scenarios:

- Compensation paid to executive officers that was not approved by the compensation committee
- Compensation paid to immediate family members of any executive officer (even if approved by the compensation committee)
- Amounts paid by the company to an executive for use of the executive's aircraft for business travel

Equity compensation plans and arrangements

When compensation is paid in company stock, the interests of existing shareholders are diluted. NYSE and NASDAQ listing requirements call for shareholder approval of equity compensation plans, with limited exceptions, giving shareholders some control over dilution. Proxy advisors consider dilution as a principal factor in their voting recommendations for approval of equity compensation plans.

Information relevant to the amount of dilution arising from equity compensation is disclosed to shareholders in a table required in the company's Annual Report on Form 10-K and in its proxy statement in years when the company is submitting a compensation plan for shareholder approval. Investors can also find more detailed information about outstanding equity in the notes to the financial statements found in Form 10-K.

Questions for directors:

- *If the committee's compensation consultant provides other services to the company during the year, does the committee regularly review that relationship for any conflicts of interest?*
- *When determining equity award packages, does the compensation committee coordinate with the audit committee and the board as a whole to consider whether the award size and its dilutive impact is appropriate?*

Current reports on Form 8-K

Public companies are required to file two types of reports with the SEC: (1) “periodic” reports on a quarterly and annual basis on Forms 10-Q and 10-K and (2) “current” reports on Form 8-K.

Among other triggering events, reports on Form 8-K are required to be filed in connection with certain compensation-related matters:

- Events tied to specific people, such as the departure or appointment of a director or NEO
- Events tied to specific arrangements such as entering into, modifying, or terminating any material compensation plan
- The results of a company’s say-on-pay vote, and the company’s determinations about the frequency of holding say-on-pay votes

Form 8-K is generally due within four business days after certain specified events. A failure to disclose certain information under Form 8-K can result in the loss of the company’s ability to use Form S-3 for capital-raising transactions, a potentially significant penalty. Because of the substantial risk involved directors should temper any inclination to take aggressive interpretive positions.

Question for directors:

- *Given the interpretive issues involved, does the company take an appropriate approach to whether Form 8-K filings are required?*

Deeper insights

Public reporting of changes in senior management or compensation decisions may sometimes be required at inconvenient times: for example, when a senior executive’s health may impede his continued ability to perform. Management may also take the view that some events will not be material to investors. Although the reporting requirements can be challenging, overly aggressive positions, such as not filing on time, can have adverse consequences to companies —even when that decision may have seemed justified by the circumstances.

"Short-swing" profit disclosure and liability

Directors and officers of public companies are subject to "short-swing" trading rules that were part of the securities laws as originally enacted in 1934. Generally, the rules require directors and officers to publicly report, in a Form 4 filing, any purchase or sale they make of the company's equity securities. If a purchase and a sale of equity securities occur within six months (regardless of the order of the transactions), the excess of the sale proceeds over the purchase price paid for a security is subject to disgorgement (i.e., forfeiture) back to the company, unless either of the transactions is exempt.

Exemption of certain transactions

Although there is no exemption from the reporting requirement, securities issued under an employee benefit plan are usually exempt from the "short-swing profit" rule, provided that the transaction is approved in advance by a committee of two or more "non-employee directors."

The rules for independence under Rule 16b-3 are different from other independence requirements applicable to compensation committee members and should be carefully followed to avoid costly errors.

For purposes of the "short-swing profit" rules, a non-employee director is one who:	
☑	Is not currently an officer of, or otherwise currently employed by, the company or a parent or subsidiary of the company
☑	Does not receive compensation, either directly or indirectly, from the company or a parent or subsidiary of the company, for services rendered as a consultant or in any capacity other than as a director, except for an amount not exceeding $120,000
☑	Does not possess an interest in any other transaction for which disclosure would be required pursuant to the related party transaction rules described on page 8

Rule 144

Compensation committee members should have basic familiarity with the purpose of Rule 144, which regularly comes up in connection with equity-based compensation awards. Rule 144 allows the public resale of stock held by "affiliates" of public companies.

Compliance is typically monitored by brokers. In most cases, compliance principally consists of filing a Form 144 with the SEC. However, Rule 144 also contains limits on the number of shares that can be sold in reliance on its provisions and on the manner in which sales can be affected.

Securities exchange listing requirements

Compensation committee charter

The securities exchanges require compensation committees of listed companies to have a written charter that specifies the scope of the compensation committee's responsibilities and how it carries out those responsibilities, including information on the structure, processes, and membership requirements. The charter must also address the compensation committee's responsibility for determining (or recommending to the board for determining) the compensation of the CEO and all other executive officers of the company. The charter should also specify how the compensation committee conducts its annual self-evaluation.

Shareholder approval of compensation plans

Unless a specific exception applies, shareholder approval is required under the NYSE and NASDAQ listing rules upon:

- Adoption of a new equity compensation plan
- Addition of shares to an existing plan
- Material revisions or amendments to the plan

For these purposes, "equity compensation plan" is broadly defined under both the NYSE and NASDAQ rules, and includes plans that provide for the issuance of new, treasury, or repurchased shares. Material revisions include:

- Any material increase in the number of shares to be issued under the plan
- Any material increase in benefits to participants
- Any material expansion of the class of participants eligible to participate in the plan
- Any expansion in the types of awards provided under the plan

Deeper insights

Proxy advisory firms can be extremely influential in swaying shareholder votes for or against the adoption or amendment of an equity compensation plan. Their recommendations are determined based on complicated standards including calculations related to dilution and on governance-related provisions.

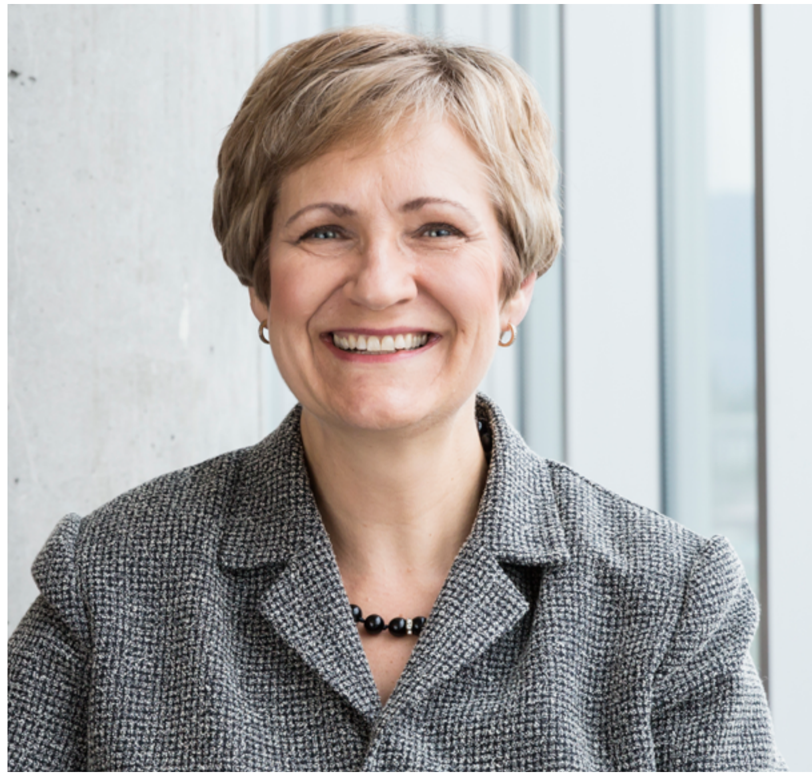
Questions for directors:

- *Since the responsibility for determining the compensation of the CEO usually rests with the compensation committee, and not the full board, does the company have formal processes in place for the full board to be briefed on CEO compensation decisions or to ratify those decisions?*
- *If the company has an equity compensation plan up for shareholder approval, has the board considered the proxy advisory services' likely vote recommendations?*
- *Has the company confirmed how votes will be counted for approval purposes?*

Proposed rules—clawbacks and hedging/pledging

In July 2015, the SEC proposed rules directing the exchanges to require listed companies to adopt policies that require executive officers to pay back incentive-based compensation that was awarded erroneously (i.e., based on accounting conclusions that were required to be restated, without regard to fault). Some respondents commented that compensation committees were not afforded any real discretion or judgment concerning if and when to pursue clawback claims.

Also in 2015, the SEC proposed rules calling for exchanges to require listed companies to disclose whether any employee or member of their board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities of the company or to pledge such company securities to secure a loan.



Deeper insights
The prevalence of clawback situations, in many circumstances tied to whistleblower claims, is increasing, in part because of new SEC reward programs. Directors are often called on to make difficult judgments.

Where do the new Dodd-Frank executive compensation disclosure requirements stand?

Focus of new disclosure requirement	Status
CEO to median employee pay ratio	Rules are final, effective January 1, 2017
Pay-for-performance alignment	Rules were proposed in early 2015, and the comment period closed in July 2015
Clawback requirements	Rules were proposed in early 2015, and the comment period closed in September 2015
Hedging of company stock	Rules were proposed in early 2015, and the comment period closed in April 2015

Independence requirements

The rules relating to director independence are both highly technical and critical because of the potential adverse consequences that can arise from mere foot faults; what may seem like an immaterial transaction or association could result in a director failing to be independent.

“Independence” from whom?
That’s a question that often comes up in connection with independence requirements. Compensation committee independence should, and for the most part does, mean independence from management—not having a relationship that might improperly influence a board member in making decisions about how to compensate executives. By contrast, audit committee independence requirements focus substantially on independence from both management and controlling shareholders.

Listing requirements

Under both the NYSE and NASDAQ listing standards, a listed company is required to have a compensation committee made up entirely of “independent” directors. The listing standards include a general facts and circumstances test and “*per se*” brightline rules.

Facts and circumstances test
The full board is required to make a determination concerning the independence of each compensation committee member and to disclose in the proxy any issues that could potentially have a bearing on a director’s independence. Companies are permitted to adopt policies that presume the independence of any director who passes the *per se* test.

Per se test
A director is *per se* not independent if he or she:

- Is an employee or recent employee of the company
- Receives certain compensation or other payments (other than board fees) from the company
- Is employed by the company’s auditor
- Has any compensation committee interlocks
- Is employed by an entity with a significant relationship with the listed company
- Has an immediate family member with certain of those relationships

SEC requirements

The SEC issued rules in 2012 directing the exchanges to establish a definition of “independence” that takes into account:

- ☑ The sources of a compensation committee member’s compensation (including consulting, advisory, or other compensatory fees paid to the compensation committee member by the company)
- ☑ Whether the compensation committee member is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer

The SEC did not create any bright lines or safe harbors for particular relationships between members of a compensation committee and a listed company.

D&O questionnaire

Directors should pay careful attention to the directors and officers (D&O) questionnaire which covers questions related to each different independence standard. Signing the form based on last year’s answers may save time in the short term, but it can cause issues later.

Deeper insights

The service of individual members of a board sometimes justifies special compensation. In those circumstances, boards should evaluate whether any special compensation can reasonably be considered compensation for service as a director, which generally should not impact independence, or whether it is compensation for services as an advisor or consultant to the company outside the contours of board services that raises independence concerns.

Deductibility of executive compensation (Section 162(m))

Section 162(m) of the Tax Code disallows a public company's deductions for compensation in excess of $1 million per year for certain top executives unless the compensation meets the requirements for an exception for "performance-based compensation" that is paid under shareholder-approved compensation plans.

To take advantage of the tax benefits afforded "performance-based compensation," the objective performance goals that determine the payout must be established by a committee comprised solely of two or more "outside directors" of the company. An inadvertent failure of a member of the compensation committee to be independent under these rules can materially impact tax filings that, for example, reflect the company taking a tax deduction arising from exercises of employee stock options.

Under 162(m), an "outside director" is a director who:

☑	Is not an employee and has never been an officer of the company or its subsidiaries
☑	Does not receive any remuneration (other than in his or her capacity as a director)—including payments for goods or other services sold by a company in which the director has a significant interest

The requirement that the director may never have been an officer of certain of the company's affiliates is a hidden issue for many companies. For example, if an individual was the founder of a business purchased by the company, he or she may be disqualified from being an outside director of the company for purposes of Section 162(m)—even if he or she was not an officer of the company at the time of purchase.

Question for directors:

- *Are other members of the board, and the board's counsel, fully aware of all personal, business, or financial connections each director has with any senior executive or with the company?*

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